APPENDIX

Revenue Act of 1934, 48 Stat. 680:

SEC. 22. GROSS INCOME.

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(c) *Inventories.*—Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income. (U. S. C., Title 26, Sec. 22.)

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SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

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(f) *Losses by Corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise. (U. S. C., Title 26, Sec. 23.)

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SEC. 117. CAPITAL GAINS AND LOSSES.

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(b) *Definition of Capital Assets.*—For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

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(d) *Limitation on Capital Losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. * * * (U. S. C., Title 26, Sec. 101.)

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Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 22 (c)–1. *Need of inventories.*—In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise in-

tended for sale. Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold, title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased, title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected.

ART. 23 (f)–1. *Losses by corporations.*— Losses sustained by domestic corporations during the taxable year and not compensated for by insurance or otherwise are deductible except in so far as not prohibited or limited by sections 23 (g), 24 (a) (6), 112, 117, 118, and 251. The provisions of articles 23 (e)–1, 23 (e)–2, 23 (e)–3, 23 (e)–4, 23 (e)–5, and 23 (h)–1 are in general applcable to corporations as well as individuals. See section 232 as to deductions by foreign corporations.

ART. 117–1. *Meaning of capital assets.*— The term "capital assets" includes all classes of property not specifically excluded by section 117 (b). The term is not limited to stocks and bonds nor to property held for more than two years. In determining whether property is a "capital asset," the period for which held is immaterial.

ART. 117–2. *Limitations on capital gains and capital losses.*—

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Section 117 (d) provides a limitation on deductions for capital losses affecting all taxpayers including corporations, that is, losses from sales or exchanges of capital assets shall be allowed as deductions only to the extent of $2,000 plus the gains from such sales and exchanges. * * *

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G. C. M. 17322, XV-2 Cum. Bull. 151-152, 155 (1936):

REVENUE ACT OF 1934

Treatment of hedging transactions for Federal income tax purposes.

The opinion of this office is requested whether losses from hedging futures transactions on commodity exchanges constitute "capital losses" subject to the limitations of secton 117 (d) of the Revenue Act of 1934, which provides in part that "* * * Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. * * *"

The instant taxpayer is a textile manufacturer. As a means of protecting itself against fluctuations in the price of cotton, the taxpayer entered into a series of hedging transactions in cotton futures which resulted in a net loss in 1934. Typical situations in which protection is obtained by the use of hedgng transactions are submitted by the taxpayer and may be illustrated as follows:

(1) The taxpayer buys quantities of spot cotton, which will necessarily be on hand for some months before being manufactured into goods and sold. In order to be protected against losses which would be incurred if the cotton market declined during

those months, the taxpayer, at the same time the above purchases are made, enters into futures sale contracts for the delivery of equivalent amounts of cotton a few months hence. As the above quantities of spot cotton are subsequently disposed of by sales from time to time of manufactured cotton goods, the above futures sale contracts are concurrently disposed of by futures purchase contracts which serve as offsetting transactions closing out the futures sale contracts.

(2) The taxpayer makes contracts for future delivery of cotton goods, the manufacture of which will require more cotton than the amount on hand or the amount which can be immediately purchased advantageously. In order to secure protection against a rising cotton market during the months that intervene between the date of the order for cotton goods and the agreed delivery date, the taxpayer, at the same time the above orders are taken, enters into futures purchase contracts for cotton in amounts necessary to provide the desired protection. As the taxpayer from time to time buys spot cotton for the manufacture of the goods specified in the above orders, the futures purchase contracts are disposed of by futures sale contracts which serve as offsetting transactions closing out the futures purchase contracts.

Such hedges, which eliminate speculative risks due to fluctuations in the market price of cotton and thereby tends to assure ordinary operating profits, are common trade practices and are generally regarded as a form of insurance (the only kind available as protection against such risks) necessary to conservative business operation. Where

futures contracts are entered into only to insure against the above-mentioned risks inherent in the taxpayer's business, the hedging operations should be recognized as a legitimate form of business insurance. As such, the cost thereof (which includes losses sustained therein) is an ordinary and necessary expense deductible under section 23 (a) of the Revenue Act of 1934 and corresponding provisions of prior Revenue Acts. Similarly, the proceeds therefrom in the form of gains realized upon hedging transactions are reflected in net income, either indirectly by compensating for losses realized on the sale of spot cotton thereby making such losses nondeductible, or directly by their inclusion in income as compensating for fluctuations in the market price of cotton adversely affecting the selling price of cotton goods or the cost of raw materials necessary to the manufacture thereof.

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It follows from the above that hedging transactions are essentially to be regarded as insurance rather than a dealing in capital assets within the comprehension of section 117 of the Revenue Act of 1934. Regardless of accounting or inventory methods in use, provisions pertaining to capital gains and losses govern gains or losses on futures contracts which are speculative. Futures contracts representing true hedges against price fluctuations in spot goods are not speculative transactions, though not concurrent with spot transactions. Futures contracts which are not hedges against spot transactions are speculative unless they are hedges against concurrent futures or forward sales or purchases.

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